MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING UNIT

POLICY DOCUMENTS

POLICY DOCUMENT ON THE REGULATORY PROVISIONS FOR THE UNDERTAKING OF VENTURE OR RISK CAPITAL ACTIVITIES BY INSTITUTIONS AUTHORISED UNDER THE FINANCIAL INSTITUTIONS ACT 1994

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POLICY DOCUMENT ON THE REGULATORY PROVISIONS FOR THE UNDERTAKING OF VENTURE OR RISK CAPITAL ACTIVITIES BY INSTITUTIONS AUTHORISED UNDER THE FINANCIAL INSTITUTIONS ACT, 1994

INTRODUCTION

1. In terms of Section 3(1) of the Financial Institutions Act 1994 (the Act), an institution may be licensed to carry on the business of a Financial Institution through the undertaking of activities which are listed in the Schedule to Section 2 of the Act. One of the activities included in the list is **venture or risk capital.**

2. Section 3(2) of the Act states that:

   "In the event of reasonable doubt as to whether an activity constitutes the business of a financial institution, or whether the business of a financial institution is or is not being transacted in or from Malta by any person, the matter shall be conclusively determined by the competent authority."

3. Section 13(1) of the Act states *inter alia* that:

   "It shall be the duty of the competent authority … to ensure that financial institutions carrying on business in Malta comply with this Act … and with the conditions of their licenses …"

4. In view of these statutory obligations and responsibilities, the competent authority[1] therefore deems it appropriate to state its general views on the undertaking of venture or risk capital activities by institutions licensed under the Act.

PURPOSE OF THE POLICY DOCUMENT

5. This policy document is consequently being issued for the following purposes:

   a) to foster understanding between financial institutions and the competent authority in relation to what constitutes venture or risk capital activities;

   b) to create awareness among financial institutions undertaking venture or risk capital activities of the requisites which the competent authority considers appropriate for such activity;

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[1] *In terms of Legal Notice 324 of 2001 the Minister of Finance appointed the Malta Financial Services Authority as the competent authority for the purposes of the Act.*

c) to facilitate the monitoring by the competent authority of venture or risk capital activities carried out by financial institutions licensed accordingly;

d) to assist financial institutions, licensed to carry out venture or risk capital activities, in the assessment of whether particular business transactions involving acquisition of equity would qualify as venture or risk capital; and

e) to assist financial institutions, licensed to carry out venture or risk capital activities, in ensuring compliance with the conditions of their licence in entering into the activities referred to in item 'd' above.

VENTURE OR RISK CAPITAL

6. The competent authority considers venture or risk capital as being risk finance of a temporary nature provided to companies that, for a variety of reasons, are either unable to raise such finance in the public or unquoted markets or, in the local context, where the present shareholders would prefer to offer an allotment of new shares in the company to a financial institution on a short to medium term, rather than to any other permanent third party. Therefore, venture or risk capital is an activity that goes beyond a strategic investment in equity.

7. In this regard, financial institutions are to be guided by the circumstances that call for the provision of venture or risk capital, as highlighted in paragraph 10 below, in contrast to circumstances involving a straight acquisition of equity for investment purposes - an activity not provided for by the Act. Usually a straight investment in equity does not involve the purchaser of the shares into commitments other than those related to the acquisition of such shares.

8. Venture or risk capital is also considered as finance that is complementary to any banking facilities that are made available to the company.

9. The competent authority will, in particular but not conclusively, refer to the following criteria to determine whether an activity falls within the definition of venture or risk capital:

   (a) the percentage of the investee equity;
   (b) type of business;
   (c) stage of development
   (d) reasons for request of finance; and
   (e) agreement periods and/or exit clauses.

CIRCUMSTANCES CALLING FOR THE PROVISION OF VENTURE OR RISK CAPITAL[(2)]

10. There are various types of venture capital which mainly differentiate at the stage of development of the investee company when the financial institution decides to enter into a venture capital agreement. The following are the main circumstances that would generally qualify for the provision of venture or risk capital:

Seed Capital

Capital is provided at a very early stage, e.g. to build a prototype of an innovative idea and to conduct a limited test market, or to write a business plan and build a management team to a point where the business can be funded as a start up by a larger venture capital company. A typical seed investment carries the highest risk of all investments and is unlikely to show a return for the financial institution for 7-10 years. For these reasons, the high risk and the long time scale, the returns and the investments which do succeed must be very large to pay those which do not.

Start Up Capital

Capital to fund a start-up. The products are usually developed, a management team is in place and with probably some data on the market. Here the risk is normally considered to be high in most cases and consequently a financial institution is likely to have its funds invested for 5-10 years.

Early Stage Development

Capital to fund the development of a business which is established in a small way but which needs capital to expand and may be unable or unwilling to raise this as debt (usually because it has exhausted its ability to offer security to a bank). Risk in this type of investment could be high although slightly lesser than in a *start-up*. The financial institution would therefore normally seek an exit in 4-7 years.

Later Stage Development

Capital for a more mature business, probably with a profitable track record of several years seeking capital to develop e.g. to open a second factory or to establish a marketing network overseas. The risks could be less and consequently the time to realization would also be less to about 2-5 years.

Management Buy-Outs

Capital to fund the change in ownership of an existing, usually profitable business. The capital invested simply enables change of ownership and is

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2 *Exit periods indicated are given for indicative purposes only.*

normally more considered as *traditional corporate finance* rather than venture or risk capital. The risks could be low and the time to realization may be quite short, though the sums of capital could be quite large. Consequently a financial institution would seek to exit in 2-3 years. This concept applies also to *Management Buy-Ins* and *Leveraged Buy-Outs* although the latter type involves higher risks with probably longer exit periods.

11. The key elements which all these investments have in common and which characterize them as venture capital are first that the primary aim of the investment is to make a large capital gain over a period of years rather than to earn a small return in a few months or to receive annual dividends or interest. Secondly, the investor will take an interest in the companies in which he invests. The financial institution would therefore normally appoint a director on the Boards of Directors of the companies in which it invests and who would be expected to attend Board meetings and give additional advice and help where necessary. There will thus be a long-term relationship between the financial institution as the venture capitalist and its investees. It is important that each side choose their partner with care.

12. In its monitoring of venture or risk capital activities that can be undertaken by financial institutions licensed accordingly, the competent authority deems the circumstances included in paragraph 10 as being typical situations. This, of course, does not exclude the possibility of other particular circumstances which would warrant the provision of venture or risk capital.

THE MAIN CHARACTERISTICS OF VENTURE OR RISK CAPITAL

13. The competent authority recognizes that venture or risk capital:

    a) could involve equity, potential equity participation or participation through other debt instruments and subordinated debts in companies;

    b) is of a temporary nature, namely short to medium term;

    c) contains a degree of interest with entrepreneurial management teams; and

    d) is governed by an agreement and exit routes between the financial institution and the investee company.

14. However, in its recognition of the foregoing characteristics, the competent authority presumes that:

a) equity participation will not amount to the assumption of control[3] of the investee company by the financial institution providing venture or risk capital;

b) the acquisition of equity by the financial institution will include an exit route;

c) the financial institution providing venture or risk capital could be represented on the Board of Directors of the investee company;

d) any eventual presence of the financial institution on the Board of Directors of such investee company should be mainly geared towards monitoring the progress of the investee company and its utilization of the finance provided through venture or risk capital and other related facilities.

15. Therefore, in their evaluation of business proposals linked with the acquisitions of equity, financial institutions licensed to undertake venture or risk capital activities have to be aware of the statutory and regulatory implications.

16. Financial institutions that are subsidiaries of credit institutions authorised in terms of the Banking Act 1994 are to be guided by the provisions of Section 15(1)(d) of the Banking Act 1994 which considers the acquisition of share capital on a consolidated basis.

TYPES OF CAPITAL ELIGIBLE FOR VENTURE OR RISK CAPITAL PURPOSES

17. Since the provision of venture or risk capital could involve a variety of business situations with different capital financing and different exit routes, the competent authority deems appropriate the acquisition by financial institutions of the following categories of capital amongst possible others:

- Equity or Ordinary Shares
- All types of Preference Shares
- Debt Instruments
- Subordinated Debt

18. Financial Institutions are, however, encouraged to evaluate all the legal obligations that they would enter into pursuant to the acquisition of a given category of capital.

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3 *In this regard, control would mean the power to determine the financial and operating policies of the investee company whether through majority equity participation or otherwise.*

VENTURE OR RISK CAPITAL AGREEMENTS

19. In relation to venture or risk capital agreements, the competent authority is aware that these, like exit routes, may take different forms depending on the circumstances that underlay the particular venture or risk capital transaction. Such agreements may range from the *Founder Shareholders' Agreement* in case of new companies to the terms included in a sanction letter issued to an existing company in connection with the granting of credit facilities which would accompany the venture or risk capital transaction.

20. In any event, as long as the agreement encompasses characteristics that are included in paragraphs 13 and 14 above, the financial institution may consider such agreement as compliant to the views of the competent authority on the subject irrespective of the form which the agreement may take.

EXIT ROUTES

21. In considering venture or risk capital as a business activity involving a short to medium term commitment the competent authority recognizes that there are no hard and fast rules in the formulation of exit routes. In taking this stance, the competent authority also takes into account the underlying factors, namely, the actual business performance of the investee company as compared to the anticipated one and general market opportunities that may prevail at the time of exit.

22. At the same time, the competent authority deems it opportune to highlight the crucial importance of exit routes when a financial institution evaluates particular venture or risk capital activities. In this respect, the competent authority expects that the terms of a given venture or risk capital transaction should include the exit route as applicable to such transaction.

23. Therefore, in their endeavor to seek advantageous conditions when undertaking venture or risk capital activities, financial institutions may opt for exit routes that are as wide as possible. In this regard, financial institutions are expected to ensure that they are not restricted either by terms or conditions in the venture or risk capital agreement itself or by the clauses and articles of the Memorandum and Articles of Association of the investee company, to transfer their acquisition as freely as possible.

24. Within the context of paragraphs 21 to 23 above, the competent authority appreciates that exit routes may need to be tailor-made for each and every venture or risk capital transaction to suit the particular properties and characteristics of such transaction.

CONCLUSION

25. When financial institutions evaluate whether a proposed transaction would qualify as a venture or risk capital activity, they are also expected to consider in general paragraphs 26 to 28 below.

26. The financial institution, as the provider of venture or risk capital, should be more of a stimulant to the growth of the investee company rather than its controller[(4)] or manager.

27. Providing venture or risk capital goes beyond the mere investment of funds because of the greater inherent risks involved and of the different investment oriented characteristics that are generally highlighted in paragraphs 6 to 9 above.

28. In spite of the variety of agreements and exit routes that may be applied to venture or risk capital transactions, such transactions should be of a temporary short to medium term nature not representing control in the investee company and should be legally enforceable.

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4 *In this regard, control would mean the power to determine the financial and operating policies of the investee company whether through majority equity participation or otherwise.*